KMC Telecom Holdings, Inc. Corporate Office
1545 Route 206, Suite 300
Bedminster, New Jersey 07921

Fax 908.719.8775
Tel 908.470.2101

Michael A. Sternberg
President and
Chief Executive Officer

EX PARTE OR LATE FILED

February 1, 1999

Honorable William E. Kennard
Chairman
Federal Communications Commission
1919 M Street N.W.
Washington, D.C. 20554

CC Docket 96-98

Re: KMC TELECOM INC.'S PROPOSAL FOR INCENTIVES FOR PERFORMANCE OF SECTION 251 AGREEMENTS

Dear Chairman Kennard:

I am writing to you on behalf of KMC Telecom Inc. ("KMC"), a competitive local exchange carrier ("CLEC"), to propose that the Commission explore and adopt additional incentives that will encourage the incumbent local exchange carriers ("ILECs") to comply with their obligations under the Telecommunications Act of 1996.

KMC and its affiliates are currently providing facilities-based local exchange service in competition with the ILECs in eleven states. KMC has 23 fiber networks in place that serve approximately 50 cities. KMC has entered each new market as a reseller of the ILEC's service. Upon completing construction of its own networks, KMC has made its facilities-based local service available to its customers. To extend the reach of its networks, KMC purchases unbundled elements ("UNEs"), principally loops, from the ILECs. Unfortunately, it has been KMC's experience that the ILECs repeatedly miss due dates scheduled for installation of UNEs and fail to properly coordinate conversions of unbundled loops and interim number portability ("INP"). When due dates are missed and conversions are mishandled, KMC's business reputation and its ability to compete suffers.

While a great deal of effort has been expended on both the federal and state levels evaluating various methods for measuring the ILECs' performance of their obligations under the Telecommunications Act, little has been done (outside of the Section 271 context) to create incentives for the ILECs to comply with those obligations. KMC submits that the proposal outlined below will create such incentives and hopefully will convince the ILECs that it is in their business interests to treat CLECs in a nondiscriminatory manner.

Introduction

Section 251 of the Telecommunications Act of 1996 created a duty for ILECs to provide other telecommunications carriers with a variety of services and facilities for their use in offering competitive local exchange services. These duties include, among other things: (1) interconnection to the ILEC's network at any technically feasible point; (2) access to unbundled network elements, including local loops, signaling, databases, operator services, switching and transport functionalities; and (3) the ability to resell basic local exchange services and all optional services and features at a wholesale discount.

Although the Telecommunications Act created these legal duties, it left the details of enforcing them to negotiation between carriers and/or arbitration by state public utility commissions. The first three years of experience under the Act have shown that effective enforcement provisions are critical. The Act creates an inherently unstable situation – ILECs are required by law to provide services and facilities to "customers" who will use these offerings to compete against them. They have no incentive, other than the threat of regulatory discipline, to provide a high quality of service to their competitors. As a result, CLECs have suffered from slipshod ordering practices, delayed installations, missed appointments, lack of coordination in customer cut-overs resulting in service disconnections, and a host of other service disruptions. Both the Commission and various state commissions have recognized repeatedly that the ability of CLECs to compete with and win customers from an ILEC is seriously impaired when the ILEC engages in such service-affecting practices.

To succeed in the competitive marketplace, facilities-based CLECs need access to the ILEC's UNEs to fill in gaps in their network coverage. Resale is an effective market entry vehicle that can be used to develop a customer base until a CLEC has constructed its own network. Because of the relatively small wholesale discounts, however, resale yields very slim margins and is not likely to prove profitable in the long run. The recent financial troubles experienced by USN, one of the first resellers in the market, demonstrate that turning a profit on resale is an uphill (and perhaps unwinnable) battle. For this reason, it has become more and more difficult for CLECs that are not facilities-based to raise capital. Even for facilities-based CLECs, Wall Street wants assurances that CLECs can win customers from the ILECs and serve them over their own networks. Access to capital dries up when CLECs are unable to demonstrate that they can migrate customers to their own networks. Investors focus on the bottom line and are unmoved by complaints that the ILECs are to blame for hampering the CLECs' ability to convert customers more quickly and transparently. If capital is not available to CLECs, the goals of the Telecommunications Act will not be realized.

The legal obligations imposed on ILECs by the Telecommunications Act have not proven sufficient to incent ILECs to provide an acceptable level of service to CLECs. KMC submits that the time is ripe for trying a new approach that will convince ILECs that providing good service to CLECs makes good business and economic sense.

A New Approach To Incenting Better Performance

The performance standards (to the extent there are any) contained in the first generation of interconnection agreements (many of which are due to expire this year) do not adequately address the actual problems associated with ordering and provisioning UNEs and INP that CLECs have encountered in their day to day dealings with ILECs and are generally so lax that ILECs would have to expend a lot of effort not to be in compliance. As a result, the remedies provided for specified performance breaches, which are usually in the form of liquidated damages, are not readily available so as to incent the ILECs to improve their performance or treat CLECs like the large wholesale customers that they are, rather than as competitors.

In an effort to induce ILECs to improve their UNE and INP ordering and provisioning processes, more precise performance standards and stronger remedies must be incorporated into interconnection agreements and/or state and federal regulations to incent the ILECs to comply with their obligations under the Telecommunications Act. KMC submits that, in order to achieve the desired effect, the remedies must be self executing and must be triggered immediately when an ILEC fails to meet a minimum level of performance. In addition, the remedies must be tailored to compensate the CLEC for the lost revenues and loss of customer good will that result when the ILEC (1) fails to provide a CLEC with a timely firm order commitment (FOC) specifying a due date for installing an unbundled loop, other UNE or INP or, (2) fails to meet the due date specified in a FOC.

Performance standards and remedies are the subject of regulatory proceedings pending before the FCC and a number of state commissions. The proposals being debated include the nature of the standards, acceptable deviations from parity requirements, reporting requirements and (on the state level at least) penalties for failure to comply with performance benchmarks. All of the pending proposals contemplate legal or regulatory solutions to what is a very real business issue. In the competitive marketplace, businesses do not perform because of the threat of legal or regulatory penalties for failure to perform. Businesses perform to make money and improve the bottom line. KMC believes that regulators and industry members must recognize this fact of life in the context of implementing incentives to improve ILEC compliance with installation due dates. Adopting a business, rather than a legal, solution to a business problem is likely to do more to discourage anticompetitive behavior on the part of the ILECs than any threat of regulatory penalties.

Both the end user and the CLEC suffer when an ILEC fails to meet a scheduled due date. In contrast, the ILEC benefits from any delays in migrating a customer to a CLEC's service by continuing to collect revenues from the customer. One mechanism for alleviating the inconvenience to the customer, avoiding the potential for lost revenues to the CLEC, and for ensuring that the ILEC does not profit from delays in cutting a customer over to a CLEC's service is to require ILECs who fail to meet scheduled due dates or who fail to provide timely FOCs to immediately convert the affected customer to the CLEC's resale service until the cut over is completed. When customers are converted to a CLEC's resale service under these circumstances, the wholesale discount should be 65% off of the retail rate for the service. Although this "incentive" discount is significantly higher than the resale rate applicable in any jurisdiction, it approximates the margin a CLEC would realize when providing local exchange service using its own network facilities in combination with UNEs obtained from the ILEC. As such, it would serve to compensate the CLEC for the revenues lost as a result of the ILEC's delays in provisioning the UNEs.[1] In addition, the ILEC should be required to waive nonrecurring charges for any UNEs not provided by the scheduled due date.

KMC's proposal is consistent with remedies being implemented by various state commissions designed to incent ILECs to meet performance standards and benchmarks in connection with their efforts to meet the nondiscrimination and parity requirements of Section 271 of the Telecommunications Act. For example, in New York, Bell Atlantic has agreed to increase the wholesale discount and to reduce UNE prices for CLECs to which it provides below-standard service over a thirty day period. In Texas, Southwestern Bell has agreed to a two tier penalty structure for failure to meet due dates. Under the first tier, Southwestern Bell must pay CLECs liquidated damages to remedy the specific harm caused by its failure to perform. Under the second tier, Southwestern Bell must pay fines to the Texas State Treasury when its overall performance falls below a certain level and adversely affects competition.

Whether the financial penalties adopted in New York and Texas will succeed in incenting the ILECs to improve their performance in delivering UNEs to CLECs remains to be seen. KMC submits that its proposal represents a refinement of the approaches adopted in New York and Texas that will produce pro-competitive results more rapidly. KMC's proposal has several advantages over the New York and Texas remedies. First, it is self executing and provides immediate relief to the CLEC and the end user. Second, it will reduce litigation time and costs by eliminating the need for CLECs to bring claims for damages caused by the ILECs' failure to meet performance standards before state or federal regulatory agencies or courts. Finally, it helps to minimize the harm caused to CLECs and end users even if the ILECs do not improve their performance. By requiring the ILEC to convert the CLEC end user to resale service at a 65% discount immediately when a due date is missed, (1) the CLEC is able to earn the margin it would otherwise have realized had the UNEs been timely provided, (2) the end user is able to begin receiving service from the local exchange carrier of its choice on the due date promised, and (3) the ILEC is denied at least some of the financial benefits that accrue from continuing to provide service to the end user beyond the scheduled due date.

KMC submits that implementation of its proposal will go a long way toward qualifying the RBOCs for interLATA relief under Section 271 of the Act. One common thread running through every Commission decision denying the RBOCs Section 271 relief is the RBOCs' failure to make access to their operating support systems ("OSS") available to CLECs on a nondiscriminatory basis, a factor which the FCC has repeatedly found significantly impairs competition. Ordering and provisioning are OSS functions on which the RBOCs consistently have come up short. Because KMC's proposal would significantly reduce the anticompetitive impact of an RBOC's failure to meet a scheduled due date or provide a timely FOC, RBOC entry

---

[1] The wholesale discount should revert to the normal rate if and when the ILEC is prepared to install the service originally ordered by the CLEC or if the CLEC fails to accept that service or prevents the installation.

into the interLATA market could be hastened where the RBOC incorporates KMC's self executing proposal into its interconnection agreements and fully complies with the requirements.

A New Approach To Promoting Competition In The Residential Market

Almost three years after the passage of the Telecommunications Act, there is almost no facilities-based competition in the residential market. The biggest factor contributing to the lack of competition is the expense of constructing facilities, especially loops, to serve residential customers. While ILECs often accuse CLECs of engaging in cream-skimming by targeting their marketing efforts to the more lucrative business market, the uncertainty surrounding the ILECs' obligation to combine UNEs for CLECs and the ILECs' right to separate UNEs has hampered the development of competition in the residential market. Where the ILEC refused to do the combining or insisted on separating UNEs, a CLEC was required to collocate in every central office in which it wanted access to UNEs, thereby significantly increasing its capital expenses.

Because an RBOC must demonstrate that at least one competitor is providing facilities-based service to residential customers in order to qualify for Section 271 relief, the absence of facilities-based competition will continue to frustrate the RBOCs' efforts to enter the long distance market. The RBOCs could remedy this situation by agreeing to combine UNEs for CLECs that use the UNEs to serve residential customers. Although the Supreme Court's recent decision in the Iowa Utilities Board case would seem to mandate this result, the decision has raised new questions relating to the access to UNES that ILECs must make available. KMC submits that, until the latter issue has been resolved by the Commission, a voluntary commitment by the ILECs to continue providing access to the UNEs defined in the Commission's (now vacated) Rule 319 will make it more economically feasible for facilities-based CLECs to serve the residential market through a combination of their own facilities and UNEs purchased from the ILEC.

KMC urges the Commission to institute a proceeding to implement these business-oriented proposals to promote the development of facilities-based local competition.

Respectfully submitted,

Michael A. Sternberg
President and Chief Executive Officer

cc: Commissioner Susan Ness
Commissioner Harold Furchtgott-Roth
Commissioner Michael Powell
Commissioner Gloria Tristani
Larry Strickling, Esq.